

Alert Update

New ESMA Guidance on European Short Selling Rules — Effective 1 November 2012

18 October 2012

On 10 October 2012 the European Securities and Markets Authority (“ESMA”) published guidance in the form of Questions and Answers (the “Q&A”)¹ on the implementation of the new EU Short Selling Regulation (the “Regulation”).² The Regulation places new restrictions on short sales of securities traded in EU markets and EU sovereign debt, including credit default swaps (“CDS”) that are referable to EU sovereign debt, as well as requiring certain private and public disclosures.³ This *Alert* assesses some of the more significant guidance from the Q&A including (1) the scope of the jurisdiction of the Regulation and its application to non-EU markets, (2) the method of disclosure obligations, (3) the calculation of a net short position in a given market and (4) the differing disclosure requirements for management entities engaged in a variety of activities.

Status of the Q&A

Guidance from ESMA (including the Q&A) is not legally binding and is not EU law. ESMA is a supervisory authority established within the EU to work with regulators in EU countries to ensure coordination, monitoring and harmonisation of technical rules within the EU. However, because ESMA is the European Commission’s securities and markets adviser, its guidance carries a great deal of weight and compliance with ESMA’s guidance may be viewed as indicative of compliance with the underlying rules set forth in the Regulation.

Scope of the Regulation and Jurisdiction

The Q&A provides further perspective on the potential jurisdictional scope of the Regulation. (This *Alert* discusses the Regulation’s stated scope and the ESMA guidance thereon, although the ultimate determination of the Regulation’s reach will likely be subject to further debate.) In the Q&A, ESMA reiterates that the Regulation covers all securities admitted for trading on an EU trading venue (meaning an EU regulated market or an EU multilateral trading facility⁴), except where the principal trading venue for those securities is outside the EU — for which the Regulation specifies that there is an exemption from the disclosure requirements (see below, under “Disclosure Requirements”). The mere fact that a particular instrument is admitted for trading on an EU trading venue means that the requirements of the Regulation will apply to short sales of that instrument, irrespective of whether the instrument actually is traded on such venue. For EU sovereign debt, the defining requirement is that the financial instruments in question must be issued by (1) an EU country, (2) the EU itself, (3) the European Financial Stability Facility or (4) the European

¹ <http://esma.europa.eu/news/ESMA-publishes-update-QA-Short-Selling-Regulation?t=326&o=home>.

² EU Regulation No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF>).

³ For information on the short selling restrictions, please see our 5 October 2012 *Alert*.

⁴ A multilateral trading facility (or “MTF”) is a trading venue that brings together buyers and sellers in a non-discretionary way, according to a defined set of rules resulting in trades — such as an investment bank’s internal crossing systems where one client’s order for a sell is matched with another client’s order for a buy, or where the orders are filled directly off the bank’s books.

Investment Bank,⁵ and any short sales of such EU sovereign debt instruments or CDS referable to such sovereign debt will be subject to the Regulation's requirements (i.e., disclosure obligations, locate rule requirement, etc.).

The Q&A indicates that the location of a person placing a trade is not relevant; irrespective of whether the trade is placed by a person in an office outside the EU, the Regulation will apply based on the above factors.⁶ As a result, persons anywhere in the world are required to comply with the Regulation.⁷

The restriction on uncovered short sales relates only to shares admitted to trading on a trading venue. That means that short sales in instruments such as subscription rights and convertible bonds (e.g., performed as part of a capital increase) do not fall within the scope of the Regulation.⁸ However, claims to as-yet-unissued shares (subscription rights, convertible bonds) may cover a short sale, provided that the availability of the new shares for settlement by the arrangement is ensured when settlement is due (e.g., the rights or convertible bonds can be converted into shares that would be available in time for ensuring the settlement).⁹

The prohibition on uncovered short sales of EU sovereign debt instruments covers all debt instruments issued by an EU sovereign issuer irrespective of the currency in which they are issued.¹⁰ Accordingly, if an EU country were to issue US-dollar denominated bonds, any person shorting the bond must cover that short sale.¹¹

Disclosure Requirements

Once every two years, ESMA will publish on its website a list of exempted shares that are not subject to the Regulation's notification and disclosure requirements because ESMA has already determined that for the preceding two years the principal trading venue for those shares was a venue outside the EU; the first such list has already been published¹² and will be updated by ESMA in two years' time. Any EU security not mentioned in that list is subject to the requirements of the Regulation.¹³ With respect to EU sovereign debt and CDS referable to EU sovereign debt, ESMA has also recently published a list¹⁴ of the applicable disclosure thresholds applicable to each EU sovereign debt issuer, so that anyone short selling EU sovereign debt or entering into CDS referable to EU sovereign debt can easily confirm whether they need to make a disclosure at the 0.1 percent threshold (with incremental further disclosures at each 0.05 percent thereafter) or at the 0.5 percent threshold (with incremental further disclosures at each 0.25 percent thereafter).

For the purposes of calculating and, if necessary, reporting, the net short position held in connection with EU securities, ESMA has clarified that positions should not be rounded, but truncated to two decimal points. (i.e., 0.3199 percent becomes 0.31 percent and not 0.32 percent).¹⁵ Disclosure is required only when a person has a net short position that meets or exceeds the initial 0.2 percent threshold and each incremental further threshold at 0.1 percent thereafter (whether upwards or downwards). No new disclosure is required if a position changes over time in between thresholds, in which case any initial threshold filing made will suffice and does not need to be updated. ESMA gives the example in the Q&A of a position of 0.3 percent net short having already been reported, which might fluctuate on a daily basis up to 0.312 percent or 0.3989 percent –

⁵ Q&A 1a.

⁶ Q&A 1b.

⁷ Q&A 1c.

⁸ Q&A 7b.

⁹ Q&A 7c.

¹⁰ Although relatively uncommon, some EU countries issue sovereign debt instruments denominated in currencies other than their own national currency — particularly where they are seeking to access alternative markets and leverage new investor bases.

¹¹ Q&A 7d.

¹² <http://www.esma.europa.eu/page/List-exempted-shares>.

¹³ A list of *all* shares admitted to trading on an EEA regulated market which identifies the relevant regulator for each share is also available at: <http://mifidatabase.esma.europa.eu/>.

¹⁴ <http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers>.

¹⁵ Q&A 2f.

meaning that the 0.4 percent threshold has not been reached and no further upward disclosure would be required, and equally, the position never fell below 0.3 percent, meaning that no downward disclosure would be required.¹⁶

Content and Timing of Disclosure

The specific content required for disclosures relating to disclosable net short positions in EU securities was set forth in a Delegated Regulation.¹⁷ At present no centralised list of disclosure mechanisms for each EU regulator has been made available for the disclosure of net short positions. ESMA will be publishing such a list on its website¹⁸ before 1 November 2012 (as this is a requirement imposed on ESMA by the Regulation).¹⁹

Many EU countries already have existing reporting and disclosure rules for persons with net short positions in certain securities (particularly EU financial sector issuers). Even though holders of net short positions may already have made a disclosure under national disclosure rules, any holders of reportable net short positions held at 3:30 pm (local time for the relevant EU market) will have to make a new disclosure under the Regulation, even if it is duplicative. The disclosure made on 2 November 2012 to report on the position as at 3:30 pm (local time for the relevant EU market) on 1 November 2012 will replace the previous disclosure made under previous national disclosure rules. ESMA has stated that the “position date” for the reporting of such disclosures should be referenced as 1 November 2012, even if the net short position has in fact been in place for several weeks or months.²⁰

If daily disclosures of reportable net short positions are received by the applicable EU regulator after 3:30 pm local time, the regulator will publish the data on the next trading day.²¹ However, regulators may choose to delay the publication of particular net short positions where they consider that the disclosure needs to be authenticated.²²

Late disclosures will constitute a breach of the Regulation and may be subject to the investigation and enforcement policies of the relevant regulator.²³ There are no safe-harbour provisions and a breach of the Regulation could potentially be viewed as a strict liability offence, although the repercussions of a breach may vary from regulator to regulator as the penalties for breach of the Regulation have not been harmonised at an EU level; the Regulation merely requires that penalties and measures for breaches must be “effective, proportionate and dissuasive”.²⁴ The Regulation requires that in advance of 1 November 2012, ESMA must provide a list on its website²⁵ describing on a country-by-country basis the penalties and administrative measures in each EU country which will be applicable to any breach of the Regulation. In the UK, by way of example, the Financial Services Authority has stated²⁶ that it will apply its current penalty regime — meaning that it could (1) publish a public censure (stating that Person X has breached the short selling rules and has been reprimanded), (2) impose a financial penalty or (3) if the person is a UK FSA authorised firm or an approved person, it could place a temporary or permanent prohibition on that firm or person prohibiting them from conducting regulated activities in/ from the UK.

Calculating Net Short Position — Aggregation of Holdings and Other Issues for Investment Managers

The Q&A provides additional information and guidance on which entity or entities have a reporting obligation when there are several entities in a group or within a fund management structure which have a net short

¹⁶ Q&A 2f.

¹⁷ http://ec.europa.eu/internal_market/securities/docs/short_selling/20120629-regulatory_en.pdf.

¹⁸ <http://www.esma.europa.eu/page/Short-selling>.

¹⁹ Article 9(4) of the Regulation.

²⁰ Q&A 2c.

²¹ Q&A 6a.

²² Q&A 6a.

²³ Q&A 6a.

²⁴ Article 41 of the Regulation.

²⁵ See footnote 18.

²⁶ See sections 2.22 – 2.25 of the FSA consultation paper at <http://www.fsa.gov.uk/static/pubs/cp/cp12-21.pdf>.

position in a particular EU issuer and when these positions also have to be aggregated and reported. In addition, annexes to the Q&A explain the following scenarios in diagram format:

Entity by Entity Assessment: The Regulation requires that any person (whether a natural person or a legal person such as a company, fund or managed account) that has a net short position in an EU issuer which has reached or exceeded the 0.2 percent disclosure threshold (or the subsequent 0.1 percent thresholds thereafter) is required to make a disclosure to the relevant regulator.

Discretionary Manager Assessment: The Q&A indicates that where a manager has discretionary management authority for several funds or managed accounts, the manager must:

- (i) Assess for each fund and managed account whether any of them has a disclosure obligation, and must make the applicable disclosures in the relevant fund's or managed account's name(s)²⁷ and
- (ii) Aggregate those funds and managed accounts that each have a net short position (even if those positions individually are beneath the initial 0.2 percent disclosure threshold) and report to the relevant regulator the total aggregated net short position in the name of the manager (assuming the aggregate position reaches or exceeds the initial 0.2 percent disclosure threshold).²⁸ Funds and managed accounts with a net long position in the relevant issuer are discounted for these purposes.

For umbrella funds, the calculation should take place at the level of the respective sub-funds and for master-feeder funds, the calculation takes place at the master fund level.

Discretionary Manager Conducting Additional Activities: Where a manager performs both discretionary management activities for funds and managed account clients and also performs non-management activities (including proprietary trading), the manager will be required to conduct two different and separate net short position calculations, one for each activity. For the management activities, the calculations and reporting should be conducted as set forth above (in the paragraphs numbered (i) and (ii)). For non-management activities, the manager should calculate the net short position in each particular issuer, excluding the management activities, and disclose when a relevant threshold is reached. As a result, a manager may be required to report two net short positions with respect to the same issuer: one for the management activities and the other for the non-management activities.²⁹

Groups of Managers: The reporting of net short positions in any EU issuer for groups³⁰ of fund managers is to be made at the group level.³¹ However, the Q&A clarifies that it is only the net short positions of the entities within the group that have a net short position that should be aggregated; those entities within the group that have a long position are discounted for the purposes of reporting whether the group has a disclosure obligation.³² As a result, while a manager will be required to make a disclosure on behalf of any funds or managed accounts for which it has discretionary management authority (assuming they reach or exceed a notification threshold), where a manager is a part of a group of managers under a common parent undertaking, the manager will not be required to report its own net short position in a particular issuer unless the aggregated net short position at the group level reaches or exceeds a notification threshold.³³

²⁷ In ESMA's terminology "pursuing the same investment strategy" means that a particular fund or portfolio is either long the relevant issuer or short that issuer. Q&A 5a.

²⁸ Q&A 5a and 5e.

²⁹ Q&A 5b.

³⁰ "Group" for these purposes means any undertaking in which that undertaking's parent undertaking has (1) a majority of voting rights, (2) the right to appoint or remove a majority of the members of the subsidiary undertaking's administrative, management or supervisory body and is at the same time a shareholder in, or member of, the subsidiary undertaking in question, (3) control over a majority of the shareholders' or members' voting rights pursuant to an agreement entered into with other shareholders or members of the subsidiary undertaking in question, or (4) the power to exercise, or actually exercises, dominant influence or control. The ultimate parent undertaking in any such "group" may be a single natural or legal person. (Article 2(a) of the Delegated Regulation": <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0038:EN:PDF>).

³¹ Q&A 5f.

³² Q&A 5e.

³³ Q&A 5f & 5h.

The Q&A is explicitly clear that where a manager within a group performs both discretionary management activities and non-management activities it is required, with respect to any particular issuer, to calculate separately the positions for each fund or managed account that it advises as well as the positions held by group entities and report, where relevant, the net short position in the particular issuer resulting from its discretionary management activities from any net short position resulting from its non-management activities (which would be reported at the group level as noted above).³⁴ A discretionary manager is not required to aggregate net short positions held by group entities (held as a result of non-management activities) with net short positions held by funds or managed accounts that the manager advises.

ESMA's guidance is also clear that short sales entered into by one entity within a group cannot be covered by having another entity in the group borrow or agree to borrow the shares or have that other entity within the same group obtain a locate.³⁵

Valuation of Positions

The Q&A provides further information on the treatment of certain types of securities for purposes of determining an entity's position and whether it is long or short and whether a disclosable net short position is held.

ETFs, Baskets and Indices: Disclosures are to be calculated according to issuer — whether held directly or indirectly. ESMA has clarified that positions held through indices must be included in the net short position calculation — which means that the position holder must calculate its interest in the relevant issuer in accordance with that issuer's weighting in the index.³⁶ Shares in ETFs should also be taken into account.³⁷ When looking through basket securities and ETFs, holders will not necessarily have access to the exact data on the underlying positions and instead should use the most recently available public information in order to calculate, on a reasonable efforts basis, their interest in each issuer held through the basket or ETF.³⁸

Dividend and Bonus Shares: Dividends in the form of shares that are issued on repo'd securities should not be included by the borrower of the shares in calculating its long position.³⁹ Shares received as part of a bonus share issue or share dividend distribution, however, do count towards a long position.⁴⁰

Unissued Shares: Instruments that give claim to shares not yet issued (e.g., subscription rights, convertible bonds) should not be taken into account as long positions.⁴¹ Interest rate swaps likewise may not be set off against sovereign debt in calculating the net short position.⁴² It is possible, however, to cover a short sale by entering into a repo contract afterwards with the same (or earlier, but not later) settlement date as the short sale.⁴³ A sovereign CDS position may likewise be used to hedge a risk related to another CDS position referring to the same sovereign debt.⁴⁴

EU Sovereign Debt: In the Q&A, ESMA sets forth principles and an equation for calculating the value of net short positions on EU sovereign debt using a "nominal value duration adjusted" methodology which assesses the value of the EU sovereign debt (and hence the figure for the reportable net short position) based, in part, on the nominal value and the amount of time before the sovereign debt's maturity date.⁴⁵ If an increase or

³⁴ Q&A 5g.

³⁵ Q&A 7a.

³⁶ Q&A 5d.

³⁷ Q&A 3a.

³⁸ Q&A 3g.

³⁹ Q&A 3d.

⁴⁰ Q&A 3e.

⁴¹ Q&A 3c.

⁴² Q&A 3f.

⁴³ Q&A 7e.

⁴⁴ Q&A 7i.

⁴⁵ Q&A 4a and 4b

decrease in the particular duration-adjusted nominal value causes an investor's position to cross a threshold, even without the investor having taken any investment decision, and without changes in the nominal position, such investor would still be required to make a disclosure to the relevant regulator.

More Information

For more information on the issues set forth in this *Alert*, please refer to the Q&A,⁴⁶ one of the authors or your attorney at Schulte Roth & Zabel.

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⁴⁶ A link to the Q&A is set forth at Footnote 1.